Capital Structure: A Contemporary Approach towards financing the overall operation of a firm

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Abstract: The paper entitled "Capital Structure: A Contemporary Approach towards financing the overall operation of a firm" This paper helped in gaining the knowledge in the area of capital structure and how it helps the firm to rise the finance through the various sources for various operations. The capital structure is how a firm finances its overall operations and growth by using different sources of funds. It is the proportion of debt, equity and preference share in the firm's balance sheet. The capital structure should be examined in the viewpoint of its impact on the value of the firm. A financing mix of the capital structure should be maximizing the shareholders wealth. The capital structure decision can influence the value of the firm through the shareholders earnings.

Key words:
Shareholders wealth, financing mix, capital structure decision, shareholders earnings

I. Introduction

A business enterprise has to maintain a proper mix of securities in a manner that the cost and the risk are considered to be minimum. The mix of different securities is representing the firm's capital structure. The capital structure is different from financial structure. Capital structure is the permanent financing of the company represented primarily by long term and shareholders fund but excluding all short- term credit. Thus, a firm's capital structure is only a part of its financial structure. When the firm uses the maximum of debt and equity mix, which leads the cost of capital is minimum and thereby maximizing the market price per share.

II. Patterns of capital structure:

- Capital structure with equity shares only
- Capital structure with both equity and preference shares
- Capital structure with equity shares and debentures
- Capital structure with equity shares, preference shares and debentures

III. Assumptions of capital structure Theories:

- There are only two sources of funds used by a firm: perpetual riskless debt and ordinary shares.
- There are no corporate taxes. This assumption is removed later.
- The dividend payout ratio is 100. That is, the total earnings are paid out as dividend to the shareholders and there are no retained earnings.
- The total assets are given and do not change. The investment decisions are, in other words, assumed to be constant.
- The total financing remains constant. The firm can change its degree of leverage either by selling shares and use the proceeds to retire debentures or by raising more debt and reduce the equity capital.

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- The operating profits are not expected to grow.
- All investors are assumed to have the same subjective profitability distribution of the future expected EBIT for a given firm.
- Business risk is constant overtime and is assumed to be independent of its capital structure and financial risk.
- Perpetual life of the firm.

IV. Factors determining capital structure:

(1) Cash Flow Position:

The firm should consider the future cash flow position in the mind while making the capital structure. If the cash flow position is good, the firm uses the debt capital because lot of cash is needed to make the payment of interest and refund of capital.

(2) Interest Coverage Ratio-ICR:

To find out how many times the EBIT is available to the payment of interest the interest coverage ratio is made at the right time by the firm. To use debt capital the capacity of the company will be in direct proportion to this ratio.

(3) Debt Service Coverage Ratio-DSCR:

This ratio shows the cash flow position of the company. The cash payments should be made as the preference dividend, interest and debt capital repayment and the cash available. More debt can be utilized in the capital structure shows the better position of the firm debt payment.

(4) Return on Investment-ROI:

The firm's greater return on investment increases the capacity of utilize the more debt capital in the capital structure.

(5) Cost of Debt:

The rate of interest on the debt capital is less; more debt capital can be used by the firm. Likewise, the rate of interest on the debt capital is more; less debt capital can be used by the firm. The firm can use debt capital depends upon the cost of debt.

(6) Tax Rate:

The cost of debt is should be affected by the rate of tax. The cost of debt decreases due to the high rate of tax. Tax planning is likely to have a significant bearing on capital structure decisions.

(7) Cost of Equity Capital:

By using the more debt capital affecting the cost of equity capital. If the debt capital is utilized more by the firm may lead to the increase the risk of the equity shareholders. It means the use of debt capital affected the cost of equity capital.

The limited usage of debt capital is considered to be financially good for the firm. Increasing level of the debt capital by the firm leads which to increasing the cost of equity capital. It harmfully affects the market value of the shares. This is considered should not be a good position. The firm must take efforts to avoid it.

(8) Floatation Costs:

Floatation costs include the commission of underwriters, brokerage, stationery expenses, etc. It incurred while issuing securities. Usually, the cost of issuing debt capital is less than the share capital.

(9) Risk Consideration:

There are two types of risks in business:

(i) Operating Risk or Business Risk:

Operating risk or Business risk is the risk to the firm of being unable to cover fixed operating costs.

(ii) Financial Risk:

Financial risk is the risk of being unable to cover required financial obligations such as interest and preference dividends.

(10) Flexibility:

Amount of capital could be increased or decreased in the business is meant as flexibility. Only in case of debt capital or preference share capital reducing the amount of capital in business is possible. During the firm's life time, repayment of equity share capital is not possible. Thus, issue of debt capital and preference share capital is the best for flexibility point of view.

(11) Control:

It is supposed to ensure that the control of the existing shareholders over the affairs of the company is not adversely affected at the time of preparing capital structure. When funds are raised through debt capital, the debenture holders have no control over the affairs of the company.

(12) Regulatory Framework:

Regulatory framework of government is also influenced the capital structure. For instance, banking companies not go for any other security except issuing share capital for raise funds. Likewise, to maintain a debt-equity ratio while raising funds is compulsory for other companies. Under SEBI guidelines the public issue of shares and debentures has to be made.

(13) Stock Market Conditions:

The upward or downward movement in capital market is referred as stock market conditions. The selection of sources of finance is influenced by these circumstances. Due to the high risk investors are mostly afraid of investing in the share capital. It shows the market is dull. If it is in reverse, when the capital market are merry the investors are come forward to make their investment and harvesting the profits. Thus, the firms keep in mind regarding the conditions prevailing in the capital market, while making the selection of capital sources.

(14) Capital Structure of Other Companies:

The pattern of capital structure of other companies is almost similar because almost they produce similar products, their cost of production also similar, they depend on identical technology and also they have similar profitability. Hence, at the time of raising funds a company must take into consideration debt-equity ratio prevalent in the related industry.

V. Conclusion:

Both quantitative and qualitative, including subjective judgment of financial managers, have a bearing on the determination of an optional capital structure of a firm. Moreover, the weights assigned to various factors also vary widely, according to the conditions in the economy, the industry and the company itself. Therefore, a firm should develop an appropriate capital structure.

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